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## The experience of developing countries with macroeconomic stabilisation and structural adjustment

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**KIEL WORKING PAPER No. 606**

The Experience of Developing Countries  
with Macroeconomic Stabilisation  
and Structural Adjustment

by

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and  
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# THE EXPERIENCE OF DEVELOPING COUNTRIES WITH MACROECONOMIC STABILISATION AND STRUCTURAL ADJUSTMENT\*

## 1. Introduction

The transformation of centrally planned into market economies in Central and Eastern Europe faces a number of challenges similarly confronting economic policy making in many developing countries (DCs). The economic framework of countries in both groups is often characterised by deep-seated macroeconomic instabilities accompanied by a high foreign debt burden, severe price distortions in factor and product markets, a misallocation of scarce resources, and a delinking from the international division of labour. In the 1980s, all DCs had to cope with dramatic terms of trade shifts triggered by successive oil price shocks and the concomitant rise in the costs of foreign borrowing. As a consequence, an increasing number of DCs had embarked on macroeconomic adjustment and structural reform programs since the mid-80s. Their experience should provide insights into the nature and the composition of reform programs required in formerly socialist economies to achieve a self sustained growth path. This is not to deny, that the latter countries have to solve a number of problems such as the lack of institutions essential for market economies and the privatisation of an all-encompassing public sector for which only very limited lessons can be drawn from an analysis of DCs.

The evaluation of reform experiences in DCs has led to a broad based consensus about essential elements of successful adjustment programs [Williamson, 1990]. They need to comprise tightened fiscal discipline, tax reform, liberalisation of financial markets, opening up of the trade and the capital account to international transactions, an appropriate exchange rate regime, an adequate framework for foreign direct investment, and the definition as well as enforcement of property rights. Despite the agreement about these prerequisites for a return to a sustainable development path, reforms introduced in many DCs failed to achieve the desired goals (Section 2). The causes of these failures (as well as of successes) are analysed in greater detail in Sections 3-8 with respect to macroeconomic stabilisation, exchange rate policies, financial liberalisation, foreign trade and capital

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account reform, and privatisation. An attempt is made to highlight the importance of interest groups and credibility of governments for carrying through stabilisation and adjustment programs. The lessons for Central and Eastern Europe are summarised in Section 9.

## **2. Economic Reform of DCs in the 1980s**

A first approach towards evaluating the reform experiences of DCs is provided by a classification of 41 countries according to their economic performance and types of reform applied. Table 1 divides the entire sample by per capita income (GDP) growth and annual average rate of inflation. These two variables serve as proxies for the success of DCs with stabilisation and adjustment policies. Data cover the 1977-1989 period as well as the two sub periods 1977-1981 and 1982-1989. These two sub periods take into account the exogenous shocks of the early 1980s. For most DCs the rise in oil prices in 1979/80 triggered balance of payments problems that were aggravated by the rapid decline of several commodity prices in the late 1970s and the unprecedented rise in the real cost of foreign borrowing resulting from the shift in monetary policies in industrialised countries in 1981. 1982, the year when the debt crisis broke out, was chosen as the beginning of adjustment to a new set of relative prices, and the economic performance of the second sub period should provide evidence for the ability of DCs to return to sustained growth with price stability after the initial shocks.

Overall, Table 1 mirrors the well-known slow down of economic growth in the 1980s which has led many observers to call it a "lost decade" for the developing world. The performances of individual countries show substantial differences in their adjustment to the new international environment. Korea and Thailand emerge as outstanding successes which were even able to enhance growth and improve price stability in the second sub period compared to the first. India and Pakistan maintained price stability and achieved more rapid GDP growth, while e.g. Morocco and Upper Volta reduced rates of inflation without sacrificing growth. Except for these few success cases the performance of DCs was far less favourable. At the lower end of the table the number of high inflation countries remain constant with Sierra Leone and Mexico replacing Turkey and Ghana which escaped the low growth-high inflation trap. More generally speaking, two major movements are discernible. A number of countries with medium inflation in 1977-1981 were able to stabilise prices, albeit at the expense of GDP growth, such as Indonesia, Cameroon or Congo. Others in the

Table 1 - Growth of Gross Domestic Product (per capita) and Inflation, 41 Developing Countries, period averages, 1977-1989, 1977-1981 and 1982-1989

Rate of inflation (inf)	Growth rate (y)								
	1977-1989			1977-1981			1982-1989		
	y>5	5>y>1	y<1	y>5	5>y>1	y<1	y>5	5>y>1	y<1
0<inf<10	Korea Thailand	Malaysia India Pakistan Upper Volta Congo Tunisia Morocco Cameroon	Panama Honduras Togo Senegal	Malaysia	Panama Tunisia Senegal	India Pakistan	Korea Thailand	India Indonesia Malaysia Pakistan Morocco Upper Volta Senegal	Tunisia Congo Honduras Cameroon Togo Panama
10<inf<50		Indonesia Egypt Sri Lanka Chile Paraguay Colombia Bangladesh	Kenia Ecuador Philippines Costa Rica Malawi Tanzania Guatemala Jamaica Venezuela El Salvador Nigeria	Paraguay Cameroon Chile Indonesia Congo	Thailand Egypt Mexico Korea Sri Lanka Philippines Colombia Ecuador Honduras Upper Volta Sierra Leone Kenia Togo Bangladesh Morocco Guatemala	Costa Rica Malawi Tanzania Venezuela Nigeria Jamaica El Salvador		Turkey Egypt Sri Lanka Colombia Bangladesh	Chile Kenia Costa Rica Jamaica Malawi Ghana Ecuador Paraguay Tanzania Philippines El Salvador Guatemala Venezuela Nigeria
inf>50		Turkey Mexico Brazil	Uruguay Sierra Leone Ghana Argentina Peru		Uruguay Brazil	Turkey Argentina Peru Ghana		Brazil	Mexico Uruguay Argentina Sierra Leone Peru

same inflation category such as e.g. Chile or the Philippines could not achieve more macroeconomic stability while nonetheless suffering from slower income growth.<sup>1</sup>

The evidence in Table 1 suggests that the majority of DCs seem to have implemented only half-hearted stabilisation measures which in turn have exacerbated adjustment costs in terms of foregone GDP growth. To substantiate this conclusion, the reform packages applied in those sample countries for which the required information was available were reviewed [Raiser, 1993] and classified according to their approach (shock vs. gradual) and their success (sustained vs. collapsed). Furthermore, the initial economic and political conditions of the reform countries were subdivided into "stable", "crisis" and a mixed category labelled "muddle". Obviously, all these categories are somewhat arbitrary. The term "shock" was used to denote programs that sought immediate solutions in various policy areas, while gradual reforms typically focussed on one specific sector.<sup>2</sup> Sustainability refers to the reform process itself and not to its results, following the analysis applied in Michaely et al. [1991]. And finally, the initial conditions prevailing in the sample countries were subdivided on the basis of a qualitative judgement.

Table 2 presents the results of this classification which is based on surveys provided in the literature [e.g. World Bank, 1990; Michaely et al., 1991]. Most countries had initiated economic reforms in a stage of crisis as Michaely et al. [1991] had contended. In such a situation, countries tended to apply a shock approach to economic reform which could be sustained in about two thirds of all cases listed. In those countries attempting a gradual reform in a stage of crisis, the reform inevitably collapsed. However, several countries starting from slightly better initial conditions have become very successful reformers by pursuing gradual strategies typically starting with a real devaluation, followed by a stabilisation package. Once excess absorption had been reduced, trade liberalisation and capital market reforms followed [Sachs et al., 1989; Bisat et al., 1992]. The failure of both shock and gradual reforms in particular in Latin America, can be traced to reform inconsistencies. Half-hearted attempts led to the perpetual inflation-stabilisation cycles of Brazil and

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<sup>1</sup> It has to be acknowledged, though, that Chile and the Philippines as well as some other countries were late starters managed to return to medium growth with low inflation in the second half of the 1980s.

<sup>2</sup> Korea and Thailand, for instance, did follow a broad approach to reform involving a careful sequencing of trade and capital market liberalisation [Bisat et al., 1992; Mosley et al., 1991]. On the other hand, the heterodox stabilisation programs of Brazil and Argentina in the mid-1980s are listed as gradual, although the impact of the price freeze was felt throughout the economy immediately.

Table 2 - Economic Reforms and Structural Adjustment in Developing Countries Since 1976: A Synthesis

Reform sustainability		Initial Conditions			
		Stable	Muddle	Crisis	
<i>Sustained</i>	<i>shock</i>		Sri Lanka (1977-9) Colombia (1984-6)	Turkey (1980-4) Chile (1974-81) Mexico (1985-9) Philippines (1985-9) Jamaica (1986-8) Argentina (1989- ) Bolivia (1985-7)	Ghana (1983-8) Nigeria (1986-91) Costa Rica (1981- ) Mauritius (1984-7) Israel (1985-9) Venezuela (1989 -) Morocco (1982-7)
	<i>gradual</i>	Korea (1981-5)	Thailand (1982-5)  Indonesia (1983-6) India (1985- ) Pakistan (1980- ) Malaysia		
<i>Collapsed</i>	<i>shock</i>		Philippines (1980-85)	Argentina (1976-81) Brazil (1990- ) Peru (1974-82) Uruguay (1974-82) Malawi (1981-6)	
	<i>gradual</i>		Senegal (1986-9)	'Kenia (1980-4) Jamaica (1977-83) Ecuador (1985-9) Zambia (1985-7) Côte d'Ivoire (1981-3) Brazil (1986/7) Argentina (1984/6) Tanzania Zimbabwe	
<i>No reform</i>			Venezuela (1982-9) Greece (1982- ) Egypt (1990- )	Ethiopia Nicaragua Peru (1983-91) Yugoslavia (-1990)	

Source: Raiser [1993, p. 20].

Argentina which prevented an adjustment of production structures to the new relative prices, thus causing high economic costs in terms of foregone growth.

The evidence presented in Tables 1 and 2 allows to draw a first conclusion from the reform experience of developing countries that is relevant for Central and Eastern Europe. First, there is no cookbook recipe for economic reform. Reforms have to be broad-based and, above all, consistent. Starting from crisis, success was only achieved with comprehensive approaches tackling both stabilisation and adjustment issues. The review of various reform experiments shows that reform failures were either due to half-hearted attempts in a gradually deteriorating environment, or to inconsistent or partial reforms followed by a renewed crisis. However, the essential ingredients of a comprehensive reform approach still remain to be identified. For this purpose, a more detailed evaluation of reform experiences is necessary. The reform package does not only have to take into account the initial conditions prevailing in the respective countries, but also the type and level of distortions inherited from past policies, and it has to reflect institutional deficiencies, the flexibility of markets, and the availability of factors of production.

### **3. Sequencing of Economic Reforms: A Review of the Literature**

As a first approach towards identifying major elements of successful reform programs we have surveyed the literature that has attempted to synthesise the reform experience in DCs and to design optimal reform strategies. This literature which largely draws on the reform failures in Latin America was contrasted to proposals for the transformation of post-socialist economies as they were developed in the early 1990s. This comparison is to show to what extent the recommendations for DCs were also considered as a guideline for economies in transition.

Table 3 summarises the various proposals.<sup>3</sup> Although the substance of the envisaged reform efforts in post-socialist countries overlaps with those that have been implemented in many developing countries, the challenge facing post-socialist countries is undoubtedly broader and the task more demanding. The lack of market institutions, the need for fundamental microeconomic reforms, the extent of domestic price liberalisation and the sheer quantity of firms to be privatised are of major concern and have to be taken into account in any comprehensive sequencing

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<sup>3</sup> Table 3 is only a first approximation to the underlying proposals. The effort to classify alternative proposals in a unified schematic framework is limited by overlapping reform categories, situation specific sub-recommendations, and a number of "if ... then" recommendations. Furthermore, most authors stress that all reforms have to be close to each other in time.



Table 3 - Schematic Views of Selected Sequencing Proposals\*

	Institutional Reform <sup>1</sup>	Domestic Price Liberalization	Fiscal/Monetary Stabilization	Domestic Financial System	Privatization	Trade Reform	Capital Flow Liberalization
<b>Developing Countries</b>							
Corden [1987]			1			1/2	2/3
Edwards [1984, 1990]			1	2		3	4
Fiel [1990] <sup>2</sup>			1	1		2	3
Frenkel [1982]						1	2
Krueger [1981/84]			1	1		1/2	2/3
McKinnon [1982]			1	2		3	4
Lal [1987]			1	1		3	2
Schweickert [1993]			1	2		1	3
<b>Economies in Transition</b>							
Buch [1992]				1		1	1/2
Dornbusch [1991b] <sup>3</sup>	1	4	2	5	3	4	3/4/5
Fischer/Gelb [1991]	1	2	1	4	1/3 <sup>4</sup>	2	5
Gelb/Gray [1991]	1	1	1	3	1/3 <sup>4</sup>	1	3
Hinds [1991]	1	2	1	3	1/4 <sup>5</sup>	2	
Lipton/Sachs [1990]	1	1/2	1		3	1/2	
McKinnon [1991]		3	1	2		3	4
Nuti [1991]	1	1	1		2	3	4
Roland [1990]	1	3	3	2/4	2	3/4	2/3/4
Rybczynski [1991]	1		3	1	2		
Siebert [1991]	1	3	2	3	3	3	
<p>* Only broadly defined reform areas are considered. If they do not exactly match with the analysis in the respective proposals, the closest category is chosen. Number 1(5) stands for the reform area that should be initiated first (last). The ranking refers mostly to the starting time of reforms so that different reform steps may well overlap. Obviously, the necessary time of reform may differ. Identical ranking indicates that these areas should be initiated at the same time. More than one ranking indicates that no unequivocal grouping appears possible, e.g. because the broad categories considered here are subdivided into smaller units in the respective proposals. Some analyses refer only to specific aspects of the sequencing issue. In this case, the remaining columns are not marked.</p> <p><sup>1</sup>Includes e.g. legal system, property rights, contract law, company law. - <sup>2</sup>This sequencing strategy refers less to an own proposal, but is presented as a typical sequence for developing countries. - <sup>3</sup>This sequence relates more to a big bang "7 day program". - <sup>4</sup>Small scale privatization and large scale restructuring and privatization respectively. - <sup>5</sup>Privatization of enterprises and privatization of banks, respectively.</p>							

Source: Funke [1993, p. 340].

proposal. Table 1 reflects the larger scope of sequencing proposals as well as the greater variety of individual proposals related to economies in transition. However, even beyond these dissimilarities reflecting the diverging initial conditions in DCs and economies in transition the literature reveals considerable disagreement concerning the essential components of a shock approach:

- The need for an early fiscal and monetary stabilisation is widely accepted for DCs. This view is, however, not unanimously shared in the case of post-socialist economies.
- Trade reforms should be closely linked to fiscal and monetary stabilisation in DCs as well as in economies in transition. Whether a stabilisation-first-strategy or a simultaneous implementation of - stabilisation and trade reforms is recommendable remains controversial. In economies in transition, the initiation of trade reforms should be closely related to price liberalisation.<sup>4</sup>
- The reform of the domestic financial system enjoys high priority on the reform agenda in DCs and is closely related to fiscal and monetary stabilisation. This recommendation sharply contrasts with the wide disagreement concerning the appropriate position of financial market reforms in the transformation process. While some authors favour an early financial market reform, others suggest postponing financial market reform until the end of the program.
- A fairly wide consensus of opinion is that the capital account of the balance of payments should only be liberalised in a last step. This mainstream advice for DCs and economies in transition is, however, challenged by Lal [1987].

It has been shown elsewhere [Funke, 1993] that dissenting views on reform strategies depend on the underlying approach chosen by the authors, i.e. whether they have applied an orthodox neo-classical or a political economy approach. Funke has suggested that differences between both approaches may be bridged by explicitly introducing the notion of credibility of government policy. For the present purpose it suffices to state that a consensus with respect to an optimal design of reform strategies has not emerged so far. The next step is, therefore, an analysis of the reform experience of DCs in major reform areas and a discussion of their applicability to economies in transition using the concept of credibility as an analytical tool.

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<sup>4</sup> For economies in transition, the optimal order of privatisation also remains controversial. While some authors suggest that domestic price liberalisation and/or stabilisation should precede privatisation, others recommend the reverse sequence. The distinction between small-scale and large-scale privatisation as well as the distinction between the privatisation of enterprises and the privatisation of banks plays an important role.

#### 4. Fiscal and Monetary Stabilisation

Most proposals presented in Table 3 grant high priority to early fiscal and monetary stabilisation. From the orthodox point of view, the suggestion to stabilise early in the reform process is based on the assumption that the information content of prices is higher in a relatively stable environment. High and volatile inflation may distort relative prices and therefore reduce the value of these market signals and lead to further disruption. A prior external liberalisation that takes place under wrong market signals would counteract an efficient resource allocation [e.g. Genberg, 1990]. Moving resources in and out of sectors bears considerable adjustment costs. Thus, it appears recommendable to start with basic macroeconomic reforms.

The political economy approach challenges the view that stabilisation should be undertaken immediately.<sup>5</sup> From the political economy perspective it is difficult to identify the winners and losers because different aspects of the stabilisation program may have cumulating or offsetting effects on particular socio-economic groups. The individual situation depends on the type of stabilisation program, i.e. whether a simple orthodox program is initiated or a specific currency reform that may protect lower incomes. Political opposition is likely to develop and may delay or even halt the whole program if stabilisation involves substantial short run costs, such as an initial drop in output or increasing unemployment. Starting with a politically costly measure would clearly violate the demand of the political economy approach to start with reforms that create up-front benefits.

However, it is open to question whether early stabilisation efforts necessarily result in considerable short-run costs. The credibility of the reform program plays a crucial role in determining whether short run costs of stabilisation programs are high or low, and how much time is needed to stabilise the economy. If reforms are credible, the costs of disinflation can be reduced by changing inflationary expectations [Agénor/Taylor, 1991; Dornbusch, 1991a]. A high reform credibility helps transform private agents behaviour "from being backward-looking to being forward-looking" [Edwards, 1991, p. 16]. To the extent that this credibility effect is significant, the positive effects of the anti-inflation program, namely the establishment of the public good "stability", can be achieved quickly and sustainably without a (substantial) fall in output and an increase in unemployment.

Recent stabilisation successes in DCs support the view that stabilisation programs can be implemented without high economic costs and within a relatively short period

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<sup>5</sup> For a more comprehensive analysis of the political economy of stabilisation see e.g. Nelson [1984].

of time. Bolivia, Mexico and Argentina are cases in point. In Bolivia, the economic situation has remained relatively stagnant, whereas the Mexican and Argentinean programs were accompanied by recovery and growth. Several measures were implemented to increase the credibility of the stabilisation programs. In Argentina the Austral was pegged by law to the US\$ starting from April 1991, full convertibility of the national currency was introduced; the US\$ was admitted as legal tender; and a law prohibited the financing of budget deficits by Central Bank credit [Schweickert, 1994]. After some success had been reached on the inflation front, a new currency was introduced. This provided an additional signal from the government to reinforce its commitment to low inflation. In Mexico, the program was based on the Economic Solidarity Pact, which was an agreement between the government, labour unions and entrepreneurial organisations [Kate, 1992]. The inflation rate, as measured by the consumer price index, fell from the monthly peak of 15.5 per cent in January 1988 to 1.0 per cent in autumn 1991. The decline in inflation was not accompanied by significant additional losses in output, and recovery started soon [Aspe, 1992].<sup>6</sup>

These experiences seem to suggest two conclusions: First, stabilisation policies can be successful if they are credible; and secondly, credibility is achieved by broad-based and drastic reform measures that signal the governments commitment to reform. These may be valid lessons for Russia and other CIS states which have - if anything - adopted gradual stabilisation approaches that could not reduce inflation [DIW, IfW, IWH, 1993]. One may argue, though that at least the Central European countries have in fact opted for sweeping stabilisation programs and suffered from sharply declining output and employment while inertial inflation has remained high. The reasons for these relatively unfavourable developments remain debated. Advocates of the J-curve effect of transition argue that the initial recession is nearly inevitable in any transformation process [Siebert, 1991]. Others stress negative demand effects, including the collapse of CMEA trade and of inputs and consumer goods) hoarding before price liberalisation [e.g. Brada/King, 1992]. Calvo and Coricelli [1992] point to credit supply constraints in the transition. Raiser [1992] critically evaluates the alternative explanations of the recession in the case of Poland and stresses the importance of still existing soft budget constraints<sup>7</sup> to account for the persistence of macroeconomic imbalances. Perverse incentive structures at the micro-level render stabilisation less credible and more costly.

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<sup>6</sup> Chile's 1970 stabilisation program is the only recent exception, where high inflation was successfully reduced with a gradualist approach. However, Bruno [1992] points to the high social costs of this gradual experience and doubts whether this strategy would have been feasible under a democratic regime.

<sup>7</sup> The concept of soft budget constraints was introduced by Kornai [1980].

These specific policy failures do, however, not provide reasons to postpone stabilisation or to change the orthodox policy mix consisting of budgetary discipline, tight monetary policies and an appropriate exchange rate regime. They rather point at institutional deficiencies typical for economies in transition which have to be taken into account when designing stabilisation programs and/or require additional measures complementing the stabilisation program. This point is subsequently elaborated with respect to the choice of an appropriate exchange rate regime.

## 5. Exchange Rate Regime

In order to lend credibility to their stabilisation programs many DCs have implemented fixed exchange rate regimes or a pre-announced crawling peg [see e.g. Quirk, 1989; Reisen, 1991]. The idea was to break inflationary expectations by introducing a nominal anchor and to "buy" reputation for stability-oriented fiscal and monetary policies by tying the hands of governments. An evaluation of alternative exchange rate regimes in DCs [Schweickert et al., 1992] reveals that neither policy is without flaws:

- The return to fiscal and monetary discipline is a necessary precondition for successful stabilisation, irrespective of the applied exchange rate regime. A nominal anchor may, however, induce governments to overestimate the effects of fixed exchange rates and to drag their feet with respect to tighter fiscal and monetary policies in order to avoid output and income losses.
- Flexible exchange rates facilitate the adjustment process because all prices react to policy changes while the prices of non-tradables have to carry the whole adjustment burden under a fixed exchange rate regime. Furthermore, the required fiscal and monetary stabilisation efforts become larger if the exchange rate is not fixed at the (new) equilibrium level.
- Both exchange rate regimes may impede structural adjustment. Fixed exchange rates do not allow to react to external shocks and may require sizeable reductions of real wages while flexible exchange rates may be "overshooting" in response to speculative capital movements. In both cases, a misallocation of resources would ensue.

The last observation is of particular relevance for economies in transition. Given their substantial need for structural adjustment, the exchange rate regime and other stabilisation measures should be carefully evaluated with respect to their impact on the microeconomic incentive system. Appropriate and credible market signals to economic actors are indispensable preconditions both for the sustainability of

stabilisation and a rapid economic recovery. Judged by the experience of DCs, chances seem to be greater with flexible than fixed exchange rates that relative prices actually indicate scarcities.

Several experiments with fixed exchange rates in Latin America did not yield very convincing results. Time and again, the combination of fixed exchange rates and persistent inflation differentials led to a real appreciation of the currency, thus endangering the international competitiveness of exports [Kiguel, Liviatan, 1990]. One exception be the most recent peg of the exchange rate in Argentina, which has been maintained for more than two years.<sup>8</sup> The Argentinian example reveals, however, that anti-inflationary reputation can not simply be imported by fixing the exchange rate to a stable currency. Besides the above mentioned specific measures (Section 4) demonstrating the government's commitment, credibility was enhanced by a broad based approach. In particular, fiscal consolidation made substantial progress and was facilitated by the ambitious privatisation program as well as the improvement of the tax collection. Lacking privatisation revenues and a full debt service in the future may pose a serious threat to the sustainability of the current regime.

## 6. Internal Financial Liberalisation

In the past two decades, a number of DCs have deregulated their domestic financial markets as part of a broader liberalisation strategy [for a survey, see Fischer, Reisen, 1993: Table 4, p. 36f.]. The objectives were twofold: positive real interest rates for both depositors and borrowers should reflect the scarcity of capital, and easier access to capital markets was to increase competition and thereby the intermediation capacity of the financial system. Measures taken included deregulation of interest rates, scaling down of reserve requirements, curtailing of preferential credits from the Central Bank, denationalisation of banks, and relaxation of restrictions for the operations of foreign banks. The purpose of these reforms was to increase domestic savings and to improve the allocative efficiency of capital, thus stimulating economic growth.

Although domestic financial market reform is related to microeconomic adjustment, there are also close links to macroeconomic stabilisation. Repressed financial markets in DCs are typically the consequence of high budget deficits. The financing of large fiscal deficits by the inflation tax necessitates high reserve requirements and

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<sup>8</sup> For a detailed analysis see Schweickert [1994] and Reisen [1993]. Reisen suggests the Argentine currency to be grossly overvalued.

low interest rates on deposits to maintain the base on which the inflation tax is collected [McKinnon/Mathieson, 1981]. Therefore, financial market liberalisation is only sustainable when the fiscal deficit is under control or the necessary measures to regain fiscal control have seriously been started. Credibility considerations support the view that financial market liberalisation should be closely linked to fiscal and monetary stabilisation. A close link may signal to the public the government's willingness to continue its anti-inflationary policies in the future. In contrast, delaying financial market reforms would increase doubts about the government's true objectives under such circumstances. A financial market liberalisation prior to fiscal and monetary stabilisation would clearly be inconsistent and thus also incredible. A domestic financial market liberalisation is hardly sustainable, as long as the government has to rely on the inflation tax to finance government expenditure.

This conclusion does not necessarily hold for economies in transition where the banking system was largely passive. Credits were allocated in order to fulfill the earlier established plans. The credit supply had hardly any relation to the underlying assets and the future prospects of the firms. Bad debts have been accumulated primarily as the result of the soft budget constraint under which state-owned enterprises were allowed to operate [Kornai, 1993]. In this institutional framework, financial liberalisation presupposes the introduction of financial discipline at the enterprise level and a solution of the bad debt problem prior to liberalisation. Such measures would also have to be implemented in order to render monetary and fiscal stabilisation credible. Continued flows of preferential credit to state owned enterprises would undermine any effort to tighten money supply.

## **7. Trade and Capital Account Liberalisation**

After more than two decades of sometimes heated debates, most development economists now agree that the external opening of DCs has significantly contributed to enhancing and sustaining economic growth and creating new employment opportunities [for a survey, see Hiemenz, Langhammer, 1989]. International competition erased monopolistic elements in domestic markets and facilitated the emergence of production patterns in line with comparative advantages; exports allowed to increase production beyond the narrow boundaries of domestic demand and to reap economies of scale; and, the inflow of foreign capital expanded the domestic savings capacity and, hence, investment. There is also little doubt that international competition and the availability of foreign capital can shorten the transition period in formerly socialist economies. Open questions are, however, whether trade liberalisation should occur simultaneously with macroeconomic

stabilisation and whether it should be accompanied by an immediate opening up of the capital account.

Opponents to a simultaneous implementation of stabilisation and trade reform programs argue that trade reform would still take place under wrong market signals as long as high inflation distorts relative prices significantly [Fischer, 1986]. Furthermore, successful trade liberalisations should be supported by a real depreciation of the exchange rate. As long as the primary source of macroeconomic instabilities, namely the budget deficit, has not yet been successfully tackled, the deficit may induce an undesired real exchange rate appreciation, which induces resource shifts to the non-tradable sector [Michaely et al., 1991]. There is also the danger that interest groups negatively affected by stabilisation and trade reform may unite and become a powerful opposition against the implementation of reforms [Falvey, Kim, 1992; Newberry, 1992].

However, a delay of trade liberalisation would perpetuate the inefficiency costs of large divergences between domestic and international prices [Krueger, 1993]. For economies in transition the main argument in favor of a simultaneous trade reform is that fiercer world-wide competition increases the pressure on domestic producers, including still existing monopolies, to increase efficiency. Liberalising trade ad hoc is the easiest way to introduce competition [e.g. Genberg, 1990]. Credibility considerations support this view [Rodrick, 1989]. The simultaneous implementation of a stabilisation program and trade liberalisation may signal the government's commitment to reform and encourage the overall reform process.

Empirical evidence for DCs reveals at least three relevant aspects. First, trade liberalisation has rather facilitated than hindered the removal of macroeconomic disequilibria [Schweickert, 1993]. Secondly, unemployment costs related to successful trade liberalisations are usually much smaller than generally expected [Michaely et al., 1991, p. 271]. The fears of the political economy perspective seem to be exaggerated. The impact on unemployment does not seem to depend on the intensity and speed of trade liberalisation. In some cases, even positive employment effects could be observed. And thirdly, the credibility of the transformation to a more open economy depended on a coherent approach to stabilisation and liberalisation which encompasses all major markets. Policy coherence was all the more important the more markets were freed from government interventions, and the more market forces were allowed to perform their function in co-ordinating individual decisions [Hiemenz, Langhammer, 1989]. In sum, the empirical evidence strongly suggests not to postpone trade liberalisation.



Concerning the proper sequencing of capital account liberalisation, Frenkel [1984] has argued that restrictions on capital flows should only be lifted after free trade has been introduced because markets for financial assets adjust more quickly to new policy regimes than goods markets. The latter proposal also emerges from several studies of aborted liberalisation attempts in Chile, Uruguay and Argentina [McKinnon, 1982; Corbo et al., 1984; Dornbusch, 1984; Edwards, 1984; Sjaastad, 1984]. They conclude that liberalisation of the capital account should be postponed because capital flows would either - under a freely floating exchange rate - push the value of the domestic currency to a level which impedes the structural transition of the real sector, or - under a "tablita" or fixed exchange rate regime - require extremely high real rates of interest in domestic capital markets to maintain the chosen parity. In addition, Fischer and Reisen [1993] point to the necessary institutional reforms in domestic financial markets which should be implemented before capital controls are relaxed.

The empirical evidence remains inconclusive largely due to inconsistencies in the reform programs. Chile was the only Southern Cone country which roughly followed the mainstream recommendations. After having controlled the fiscal deficit, foreign trade was liberalised. The capital account was only opened in a third step, after domestic financial market liberalisation. The program was accompanied by changes in the exchange rate regime. Starting with a crawling peg, Chile advanced to a pre-announced exchange rate regime and finally fixed the exchange rate. The subsequent failure of the program cannot be directly related to the sequence. Closer analysis has pointed to the crucial role of the exchange rate regime. The maintenance of fixed exchange rates when wages were indexed to past inflation and lax domestic financial market regulations contributed to the failure of the program [Hiemenz/Langhammer 1989]. The negative effect of fixing the exchange rate was reinforced by the choice of the anchor (US\$), which at that time started to appreciate in world markets.

Some examples exist, where the reverse sequence took place. The reforms in Uruguay started with the deregulation of domestic financial markets and the opening of the capital account. Until the late 1970s, the program was quite successful. In particular, a real overvaluation of the currency was not observed. The initial avoidance of major imbalances appears to contradict conventional wisdom. The failure of the program did not start before the "tablita" was established and government deficits began to increase again. The inconsistent exchange rate policy may have contributed to its failure. In Argentina the capital account was also liberalised without substantial trade liberalisation and before the fiscal stabilisation was achieved. Since this combination along with a pre-announced exchange rate

regime was clearly inconsistent and thus not credible and sustainable, the program failure can not be directly related to the order of external liberalisation [Lal, 1987].

Malaysia and Indonesia present two more examples, where the capital account has been opened at an early stage. The capital account in Indonesia was first opened in 1971. Trade was only liberalised in the 1980s and interest rates in 1983. Nonetheless, Indonesia and Malaysia were successful in keeping inflation low and exchange rates competitive. Fischer/Reisen [1993] argue that capital controls would hardly have been effective, because Singapore served as a kind of informal financial market for both countries. Institutional peculiarities supported the positive development. Foreign exchange earnings from gas and oil exports were largely controlled in the past. These examples suggest that an early liberalisation should not be postponed, if the specific locational situation of a country makes capital controls largely ineffective or prohibitively costly.

Obviously, a proper sequence of trade and capital account liberalisation cannot be established easily. The extent of speculative capital movements, the chosen exchange rate regime and the possibilities for sterilised intervention play a crucial role with respect to the final outcome of this policy reform. Yet, if it is recommendable for economies in transition to choose flexible exchange rates, some degree of capital account liberalisation would also be desirable. The need for foreign direct investment and increased competition in domestic capital markets point at an early removal of controls concerning long-term capital flows. The success of such a policy crucially depends on the consistency and comprehensiveness of the whole reform package, i.e. on whether the microeconomic incentives are adjusted to the new circumstances in a credible way, so that capital flows result in additional investment and do not remain purely speculative.

## **8. Privatisation**

Another focal point of the discussion on a successful transformation process is the appropriate timing and the required sequence of privatisation. Some authors, including Lipton/Sachs [1990], proposed that privatisation should be postponed until macroeconomic stability is achieved and major distortions have been removed, in order to improve the information value of prices and to sell companies at their real market value. In contrast, others [e.g. Rybczynski, 1991; Fischer/Gelb, 1991; Hinds, 1991] favour some immediate privatisation, because private property is fundamental for the functioning of a market economy. In this respect, the experience of DCs has little to offer by way of recommendation. Only the Chilean experiments with large-

scale privatisation in the 1970s and again in the 1980s offer some insights [Agarwal, Nunnenkamp, 1992].

The conditions under which privatisation was initiated in Chile after the socialist Allende regime reveal remarkable similarities to the present situation in Eastern Europe. State enterprises dominated all important economic sectors. Domestic capital markets were weak, and basic institutional and regulatory issues unresolved. And most importantly, the Chilean privatisations started while the economy was in the midst of a drastic stabilisation and liberalisation process. The following lessons seem to emerge:

- Competitive bidding seems to be better suited for the economic transformation of Eastern Europe than alternative privatisation methods. The case of Chile indicates that the promotion of public participation in the privatisation of state enterprises involves considerable costs in terms of subsidies and preferential sales prices. However, competitive bidding is likely to fail if large private investors have easy access to public loans to finance the acquisition of state firms. Basic solvency rules need to be in place and enforced to enhance the financial stability of enterprises and banks. Furthermore, privatisation should be financed in a way that disposes the state of entrepreneurial risks and contains moral hazard of buyers.
- Another lesson relates to the sequencing of privatisation. The case of Chile does not support the view that privatisation should be postponed in order to contain negative effects on employment in the short run. It is not to be disputed that rising unemployment may undermine the political support for economic transformation. Transitional unemployment and the ensuing political problems should, however, be alleviated by adequate social security provisions, rather than conserving inefficient and inflexible production structures.
- The undercapitalisation of state enterprises, weak domestic capital markets and the drawbacks of debt-led privatisation suggest that foreign investors should be encouraged to participate in the privatisation process, particularly through debt-equity swaps, as it was the case in Chile in the 1980s.

## 9. Conclusions

The preceding discussion has shown that the experience of DCs with stabilisation and structural adjustment programs implemented in the 1980s provides valuable insights into preconditions for a successful transformation of centrally planned into market economies. Economies in transition face challenges such as the creation of

an appropriate institutional framework for a functioning market economy or the privatisation of an all-encompassing public sector which were absent in most DCs. Yet, the removal of severe price distortions in product and factor markets, an adjustment of production structures to new internal and external parameters as well as a rapid reduction of macroeconomic imbalances have been common tasks for both groups of countries.

A survey of successful and failed reform attempts in DCs immediately leads to the conclusion that policy reform packages have to take into account the initial conditions in the respective countries and need to focus on institutional and market deficiencies as well as bottlenecks in the supply of essential factors of production. For this reason, lessons drawn from the experience of DCs can only be fundamental rather than specific. A first fundamental lesson is related to the debate about shock versus gradual approaches to economic reform. The various reform elements (stabilisation, internal and external liberalisation) usually comprise institutional changes (tax system, banking regulations, privatisation) that take time, as well as policy measures that can be implemented rather rapidly (reduction of budget deficits, tariff cuts, dismantling of capital controls). The experience of DCs suggests that sustainable reforms require a combination of both types of measures, i.e. a "minimum critical effort" [e.g. Krueger, 1993]. The reform package has to include some shock elements while some institutional changes are at least started with the clear and credible perspective that they will be carried through to the end.

Credibility of reform programs, and this is a second lesson, is the key to success. To achieve credibility, the reform program has to be broad-based. The minimum critical effort has to include a sweeping approach to stabilisation as well as measures to encourage restructuring of the economy. It has to dismantle monetary and financial market distortions as well as to deregulate product and labour markets, and it has to tackle both macroeconomic disequilibria and distortions of the microeconomic incentive system. In addition to a broad-based approach, the credibility of the government's commitment to reform can be enhanced by early and comprehensive public announcements of reform objectives and reform steps as well as by the establishment of institutions that tie the hands of governments, thus reducing the likelihood of reform efforts being abandoned. Such institutional arrangements could be the establishment of an independent Central Bank and the membership in international organisations such as e.g. the GATT which subjects government policies to external control.

Concerning the components of the minimum critical effort two aspects seem to be crucial for sustainability. The first is related to the necessity to intertwine macro and

micro reforms. Stabilisation policies can hardly be credible and successful when microeconomic causes of inflation are not removed. In economies in transition, the soft budget constraint of state owned enterprises is a case in point. Likewise, stabilisation policies should not be designed without considering their implications on structural adjustment. The choice of an appropriate exchange rate regime is of utmost importance in this respect. It was shown that using the exchange rate as a nominal anchor may have supported macroeconomic stabilisation, but clearly impeded structural adjustment when the exchange rate was fixed at a wrong level. Conversely, financial support granted by the government to ease the microeconomic adjustment burdens may easily erode any stabilisation effort.

The last observation already hints at the final lesson, the internal consistency of reform programs. The critical minimum effort should comprise steps towards more fiscal discipline, a tighter monetary policy, a deregulation of domestic financial markets, a liberalisation of trade and capital flows as well as privatisation of state-owned enterprises. The appropriate mix of these measures may vary from country to country depending on the initial conditions, but the evidence surveyed in this paper clearly demonstrates that only a comprehensive implementation of mutually consistent reform measures embracing all major markets can breed success. This implies that much of the debate about the appropriate sequencing of reform measures is largely academic.

Sequencing does matter, however, when the experience of DCs is applied to economies in transition because of the differences in the institutional framework. Institutional and financial market reforms as well as privatisation have to be granted highest priority in transition economies. As long as the initial institutional vacuum is not overcome, transaction costs remain high and perverse incentive structures may persist, resulting e.g. in counterproductive interest-group activities as well as end-game-playing managers. The building-up of a western style institutional framework has to be started immediately, because of the unavoidable time period to implement such a system. Besides the establishment of a legal system, property rights, contract and company law as well as privatisation, institutional reforms in financial markets are similarly important. They also include the cleaning-up of the banks' balance sheets of the inherited debt. However, institutional reforms are only a necessary but not sufficient precondition for the desired reform progress.

A final point concerns the political framework required for sustained reforms. Based on the experience of developing Asian countries, one is tempted to conclude that only a strong, almost repressive government is able to credibly execute the necessary policy changes and to keep interest group pressures in check. The cases

of Turkey in the early 1980s, and more recently Mexico, suggest on the other hand, that some kind of pact between the peer groups in an economy may equally produce the required acceptability of disadvantages accruing from sweeping reforms. And finally, there is the success of Thailand emerging under a rather volatile political system. As economists, we do not dare to draw a bottomline from these dissimilar experiences, and therefore, the question of an adequate political system is left open for further research.

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